Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Assm. Rev. & Tax Comm. Analyst: Garnier Bill Number: AB 1208

Related Bills: AB 2797 (1998) Telephone: 845-5322 Amended Date: April 19, 1999

Attorney: Doug Bramhall Sponsor:

SUBJECT: Conformity Act of 1999

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

____ APPLIES.

__X__

SUMMARY OF BILL AND AMENDMENT

The Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), in general, conform to the Internal Revenue Code (IRC) either by incorporating the IRC by reference as of a "specified date" or by stand alone language which mirrors the federal provision. California law is conformed to the IRC as of January 1, 1998, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1998, to January 1, 1999, for taxable and income years beginning on or after January 1, 1999. Changing the specified date automatically conforms to all changes from January 1, 1998, through December 31, 1998, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to numerous changes made to the federal income tax by the IRS Restructuring and Reform Act of 1998 and certain other federal acts enacted during 1998.

This bill also would make numerous changes to specifically not conform or modify certain items in the IRC. Additionally, numerous technical changes regarding cross references and the deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 1998, and prior to January 1, 1999, are being made by this bill.

Board Position:

____ S	____ NA	____ NP
____ SA	____ O	____ NAR
____ N	____ OUA	__X__ PENDING

Department Director Date

Gerald Goldberg **5/13/1999**

The changes that would be made to California tax law by this bill, as discussed in this analysis, are as follows:

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EFFECTIVE DATE

Unless otherwise specified, this bill would apply to taxable and income years beginning on or after January 1, 1999.

BACKGROUND

As stated above, the Revenue and Taxation Code (R&TC) conforms to various provisions of the IRC as it read on January 1, 1998. Since January 1, 1998, four bills have been enacted into law that materially affect the IRC. They are:

IRS RESTRUCTURING AND REFORM ACT OF 1998 (IRS Reform Act)
TAX AND TRADE RELIEF EXTENSION ACT OF 1998 (Tax and Trade Extension Act)
SURFACE TRANSPORTATION REVENUE ACT 1998 (Transportation Act)
RICKY RAY HEMOPHILIA RELIEF FUND ACT OF 1998 (Ricky Ray Hemophilia Act)

This bill (and analysis) generally addresses the changes made by the above federal acts that were not conformed to prior to this bill

The term “section,” unless otherwise specified, means section of the Internal Revenue Code.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the departments costs.

Tax Revenue Estimate

			Personal Income Tax (in millions)			Bank & Corporation Tax (in Millions)		
	Description		**1999-0**	**2000-1**	**2001-2**	**1999-0**	**2000-1**	**2001-2**
1	Exclusion of value of meals to employee		$-1	$-1	$-1			
2	Employer Deductions for Vacation and Severance Pay	a/	Minor Gain	Minor Gain	Minor Gain	$+2	$+3	$+3
3	Certain Trade Receivables Ineligible for Mark-To-Market Treatment		Minor Gain	Minor Gain	Minor Gain	$+12	$+18	$+18
4	Exclusion-Min. Req. Distrib. From AGI for Roth IRA Conversions	b/	-	-	-			
5	Farm Production Flexibility Contract Payments		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
6	Certain Deductible Liquidating Distributions of RICs & REITs	c/				$+40	$+5	-
7	Tax Treatment of Cash Options for Qualified Prizes		Minor Loss	Minor Loss	Minor Loss			
8	Exclusion for Employer-Provided Transportation Benefits		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
9	Payments Received Pursuant to the R. R. Hemophilia Relief Fund		Insignificant	Insignificant	Insignificant			
10	Waiver of Estimate Tax Penalty		No Impact	No Impact	No Impact	No Impact	No Impact	No Impact
11	1998 Federal Technical Changes		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
	TOTALS		$-1	$-1	$-1	$+54	$+26	$+21
	Minor = Loss or gain of less than $500,000							
a/	Baseline revenue gains are projected to be $65 million for 1999-0 and $3 million thereafter.							
b/	Baseline revenue gains are projected to be $84 million for 2004-5, $101 million for 2005-6, and $99 million for 2006-7.							
	Conformity gains are estimated to be $1 million annually beginning with the fiscal year 2004-5.							
c/	Baseline revenue gains are projected to be $15 million annually beginning in 1998-9,							

BOARD POSITION

Pending.

SPECIFIC FINDINGS

1. Deductibility of Meals Provided for the Convenience of the Employer.

In general, subject to several exceptions, only 50% of business meals and entertainment expenses is allowed as a deduction (sec. 274(n)). Under the Tax Relief and Reform Act of 1997 (TRA of 1997) exception, meals excludable from employees' incomes as a de minimis fringe benefit (sec. 132) are fully deductible by the employer. In addition, the courts have held that if substantially all of the meals are provided for the convenience of the employer pursuant to section 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of section 132(e)(2).

The **IRS Reform Act** provides a new safe harbor rule for the employee exclusion and the employer deduction. Under that new safe harbor, all meals furnished to employees at the employer’s place of business meet the convenience test under section 119, if more than one-half of employees furnished meals on the premises are furnished such meals for the convenience of the employer. If these conditions are satisfied, the value of all such meals are excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether such meals are fully deductible under prior law. This provision is effective for all taxable years. The provision is effective for taxable years that the statute of limitations has not expired.

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of meals provided to employees.

This bill would conform California law with the new federal safe harbor rule as it relates to the deductibility of meals provided by an employer with the same effective date.

2. Employer Deductions for Vacation and Severance Pay.

Under **prior federal and current California law**, for deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income of the employee, regardless of whether the employee actually receives the benefit during the year. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits if an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Compensation received after the 15th day of the third calendar month after the end of the employer's taxable year in which the related services are rendered is considered received after more than a brief period. Compensation or benefits received by the employee on or before the end of the applicable 2 1/2- month period is not deferred compensation. (Temp. Treas. Reg. Sec. 1.404(b)-1T, A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc. (1996) 107 T.C. 271. In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of a substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer. While the rules of section 83 may govern the income inclusion for employees, section 404 governs the employer deduction if the amount involved is deferred compensation. The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2 1/2-month period. Thus, the vacation and severance pay were treated as received by the employees within the 2 1/2-month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer employer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

The **IRS Reform Act** provided that for purposes of determining whether an item of compensation is deferred compensation (under sec. 404), the compensation is not considered to be paid or received until actually received by the employee.

In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in Schmidt Baking. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2-month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2- month period for the compensation not to be treated as deferred compensation.

Congress intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service, or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement).

In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be used to try to circumvent other provisions of the IRC where payment is required in order for a deduction to occur. Thus, Congress expressed its intent that the Secretary will prevent the use of similar arrangements, though no inference was intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

This provision is effective under **federal law** for taxable years ending after July 22, 1998. Any change in a taxpayer's method of accounting required by the provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change will be taken into account for federal purposes over a three-year period beginning with the first year for which the provision is effective.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to employer deductions for vacation and severance pay.

This bill would conform California law to the federal IRS Reform Act law change as it relates to the accrual of vacation and severance pay. This bill would also require any state adjustment required by section 481 as a result of the change to be taken into account over a three-year period beginning with 1999.

3. Certain Trade Receivables Ineligible for Mark-To-Market Treatment.

In general under **federal and state law**, dealers in securities are required to use a mark-to-market method of accounting for securities (sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business.

A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

The **IRS Reform Act** provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the **IRS Reform Act**, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (sec. 475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The **IRS Reform Act** provision also applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer’s principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by section 475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements. The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as “securities” for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (sec. 475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (sec. 475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see sec. 446(b)).

The provision generally is effective for taxable years ending after July 22, 1998. Adjustments required under section 481 as a result of the change in method of accounting generally are required to be taken into account for federal purposes ratably over the four-year period beginning in the first taxable year for which the provision is in effect.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to the "mark to market" method of accounting.

This bill would conform California law to federal law as its relates to "mark to market" method of accounting for dealers. This bill would also require adjustments under section 481 as a result of the change in method of accounting to be taken into account for state purposes ratably over a three-year period beginning in 1999.

4. Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions.

Under **federal and California law**, uniform minimum distribution rules generally apply to all types of tax-favored retirement vehicles, including qualified retirement plans and annuities, individual retirement arrangements (IRAs) other than Roth IRAs, and tax-sheltered annuities (sec 403(b)).

Under **federal and California law**, distributions for IRAs must begin no later than April 1st of the calendar year following the calendar year in which the IRA owner attains age 70½. The IRS has issued extensive regulations for purposes of calculating minimum distributions. In general, minimum distributions are includible in gross income in the year of distribution. An excise tax equal to 50% of the required distribution applies to the extent a required distribution is not made.

Under **federal and California law**, all or any part of amounts in a deductible or nondeductible IRA may be converted into a Roth IRA. Only taxpayers with modified adjusted gross income (AGI) of $100,000 or less for the year of the conversion are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple.

The **IRS Reform Act** excludes minimum required distributions from IRAs for taxpayers 70½ years or older from the definition of modified AGI solely for purposes of determining eligibility to convert from an IRA to a Roth IRA. As under present law, the required minimum distribution would not be eligible for conversion and would be includible in gross income.

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs. California has conformed to changes made by the IRS Reform Act. The IRS Reform Act also made several other changes to Roth IRAs that are not addressed in this analysis.

SB 93 (Stat. 1999, Ch. 8) conformed California law to the other changes to Roth IRAs made by the IRS Reform Act not addressed by this bill.

This bill would conform California law with federal law as it relates to exclusion of required minimum distributions from modified AGI for purposes of Roth IRA conversions. The operative date of this provision is for taxable years beginning after December 31, 2004 (the federal operative date.)

5. Farm Production Flexibility Contract Payments.

Under **federal and California law**, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount is properly accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002.

Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15th or January 15th of the fiscal year, at the option of the recipient. This option to receive the payment on December 15th potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15th is elected.

The remaining one-half of the annual payment must be made no later than September 30th of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, regardless of whether the amounts actually are received or the right to their receipt is fixed.

Under the **Tax and Trade Extension Act,** the time a production flexibility contract payment under the FAIR Act is properly includible in income would be determined without regard to the options granted by section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or section 112(d)(3)(allowing the acceleration of all payments for fiscal year 1999) of that Act. The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

Current **California law** follows federal law in regards to the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act properly is includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform California law with federal law as it relates to farm production flexibility payments with the same effective date with respect to payments received in taxable and income years ending after December 31, 1995.

6. Treatment of Certain Deductible Liquidating Distributions of RICs and REITs.

Regulated investment companies (RICs) and real estate investment trusts (REITs) are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation which are properly chargeable to earnings and profits. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, the deduction includes any distribution made pursuant to the plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income.

However, in the case of a liquidating distribution to a corporation owning 80% of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets distributed. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income not being subject to tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain. A RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70% dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

The **Tax and Trade Extension Act** provides that any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80% corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70% dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the IRC.

The **Tax and Trade Extension Act** does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend. The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted. No inference is intended regarding the treatment of such transactions under present law.

Current **California law** conforms to the federal treatment of RICs and REITs with certain modifications. California is conformed to the federal treatment of a liquidating distribution from a RIC or a REIT prior to the enactment of the Tax and Trade Extension Act. However, California has not conformed to the modification made by IRS Reform Act section 6012(g) relating to "earnings and profits" ordinary distributions of REITs.

This bill would conform California law with federal law as it relates to liquidating distributions from RICs and REITs, effective for distributions made on or after January 1, 1999. This bill would not conform California law with federal law as it relates to “earnings and profits" ordinary distributions of REITs.

7. Tax Treatment of Cash Options for Qualified Prizes.

Under **federal and California law**, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment. Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity after winning the contest is required to include the value of the award in gross income, even if the annuity option is exercised.

Under the **Tax and Trade Extension Act**, the existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize. Thus, a qualified prize winner who may choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised. This provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998.

In addition, the **Tax and Trade Extension Act** also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial future service. Appearing in advertising relating to the prize or award is not (in and of itself) treated as substantial. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the method used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

Current **California law** is generally conformed to federal law as of January 1, 1998, as it relates to the taxation of awards and prizes.

California law specifically exempts California lottery winnings from taxable income for state purposes.

This bill would conform California law with federal law as it relates to the treatment of prizes other than California lottery winnings.

8. Exclusion from Income for Employer-Provided Transportation Benefits.

Under **federal and California law**, qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior federal and current California law, transit passes and vanpool benefits were excludable only if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to $155 per month of employer-provided parking was excludable from income. Up to $60 per month of employer-provided transit and vanpool benefits were excludable from gross income. These dollar amounts were indexed annually for inflation, rounded to the nearest multiple of $5.

Under current and prior federal and state law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

The position of the Treasury Department is that a voucher or similar item is "readily available" if an employer can obtain it on terms no less favorable than those available to an individual employee and without incurring a significant administrative cost (I.R.S. Notice 94-3, 1994 C.B. 327).

Present and prior federal and state law impose limits on the amount of annual additions that can be made to a tax-qualified pension plan. In the case of defined contribution plans, the limit is the lesser of $30,000 or 25% of compensation. For this purpose, compensation is generally taxable compensation, plus salary reduction contributions under a qualified cash or deferred arrangement, a tax-sheltered annuity, a SIMPLE plan, certain plans of deferred compensation for state and local government employees and employees of tax-exempt organizations, and a cafeteria plan.

Under the **Transportation Act,** employers are permitted to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash. Thus, under the provision, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions.

The **Transportation Act** does not change the rules regarding when a cash reimbursement for transit passes is treated as a qualified transportation fringe benefit.

The **Transportation Act** increased the exclusion for employer-provided parking to $175 per month and the employer-provided transit and vanpool benefits exclusion to $65 per month. In addition, beginning in 2002, the **Transportation Act** increases the exclusion for transit passes and vanpooling to $100 per month. Beginning in 2003, the $100 amount is indexed as under prior law. Further, no qualified transportation benefit will be indexed in 1999.

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to $100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the $100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to qualified transportation fringe benefits and annual additions to tax-qualified pension plans.

In addition, **California law** provides that gross income of an employee does not include benefits received for participation in any ridesharing arrangement in California.

A ridesharing arrangement includes:

- commuting in a carpool, vanpool, buspool, or taxipool.
- monthly transit passes used by the employee or the employee's dependents, other than dependents attending elementary or secondary school.
- free or subsidized parking.
- commuting by ferry or bicycling.
- travel to or from a telecommuting facility.
- the use of any transportation used to go to or from the place of employment that reduces the use of a motor vehicle occupied by a single person.

This bill would conform California law to the **Transportation Act** changes to the transportation fringe benefits rules. This bill would not affect the rules relating to California ridesharing arrangements.

9. Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act.

Generally, gross income does not include any damages received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of a personal physical injury or physical sickness (Code sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) are treated as payments received on account of physical injury or physical sickness regardless of whether the recipient of the damages is the injured party.

The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other than workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of section 104 were not excludable from income under that section.

The **Ricky Ray Hemophilia Act** treats payments to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products as damages received on account of personal physical injury or physical sickness described in section 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

Current **California law** is in full conformity with federal law as it read on January 1, 1998, as it relates to the exclusion from income any damages received on account of a personal physical injury or physical sickness.

This bill would conform California law with federal treatment of payments received pursuant to the Ricky Ray Hemophilia Relief Fund Act.

10. Waiver of estimated tax penalty.

This bill would waive additions to tax imposed for any underpayments of tax or estimated tax for any period before April 17, 2000, with respect to any underpayment for the 1999 taxable or income year to the extent the underpayment was created or increased by any provision of this bill.

11. 1998 Federal Technical Changes

Numerous technical changes were made to the IRC in 1998. Where California law is in conformity with the underlying federal provision affected by the technical change, **this bill** would conform to the technical change. The effective dates for the technical changes are either the later of the effective date for federal law or the effective date that California adopted the underlying federal law. This bill would conform to the following technical changes:

Clarification of the Deduction for Student Loan Interest (IRS Reform Act §6004(b)). The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Clarification of Qualified State Tuition Programs (IRS Reform Act §6004(c)). The provision clarifies that distributions from qualified state tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision clarifies that for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes the spouse of the original beneficiary.

Clarification of Education IRAs (IRS Reform Act §6004(d)). The provision provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10% tax) to any other (i.e., contingent) beneficiary under the age of 30 or to the estate of the deceased designated beneficiary. If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision also clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

Under the provision, the additional 10% tax on unqualified distributions will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10% tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made. If the beneficiary is not required to file such a return, the return is deemed to be required on April 15th of the year following the taxable year during which the contribution was made.

In addition, the provision provides that the 10% excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a "life-in-being." The provision also clarifies that, under annuity rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, regarding the exclusion from income of interest earned from U.S. Savings Bonds used to pay for higher education tuition and fees, the provision broadens the definition of higher education tuition and fees to conform to the definition used in education IRAs and state tuition programs.

Clarification of the Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment (IRS Reform Act §6004(e)). The provision clarifies the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements of “qualified elementary or secondary educational contributions” apply regardless of whether the recipient is an educational organization or a tax-exempt charitable entity.

Note: The revenue loss was included in AB 2797 (Stat. 1998, Ch. 322) as if the enhanced deduction for the computer technology and equipment was available to corporations for income years beginning after December 31, 1997, and before January 1, 2001. A $4 million loss was attributed to that bill.

Clarification of the Cancellation of Certain Student Loans (IRS Reform Act §6004(f)). The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations). In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

Clarification of Limitations for Active Participation in an IRA (IRS Reform Act §6005(a)). The provision clarifies the intent of the TRA of 1997 relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants .

Clarification of the Penalty-Free Distributions for Education Expenses and of First Homes (IRS Reform Act §6005(c)). The provision modifies the rules relating to the ability to roll over hardship distributions from certain employer-sponsored retirement plans to prevent avoidance of the 10% early withdrawal tax.

Distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20% withholding applicable to eligible rollover distributions.

Rollover of Gain from Sale of Qualified Stock (IRS Reform Act §6005(f)). Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months only if at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates, and trusts with no corporate beneficiaries. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

The provision also provides that the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

Election to Use AMT Depreciation for Regular Tax Purposes (IRS Reform Act §6006(b). For property placed in service after 1998, a taxpayer is allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the 150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system (ADS) of sec. 168(g)).

Depreciation Limitations for Electric Vehicles (IRS Reform Act §6009(c)). Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the six-year recovery period (the recovery period) of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations. Current law provides the recovery period limitations are trebled for vehicles that are propelled primarily by electricity. The provision provides that the depreciation limitations applicable to post-recovery periods under section 280F are trebled for vehicles that are propelled primarily by electricity.

Clarification of Constructive Sales Rules (IRS Reform Act §6010(a)). The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

The provision also clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Additionally, the provision clarifies that the special effective date rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the TRA of 1997.

Treatment of Mark-to-Market Gains of Electing Traders (IRS Reform Act §6010(a)). The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining "net earnings from self-employment" for the Self-Employed Contributions Act tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met, or for purposes of any other Code provision specified by the Treasury Department in regulations.

Treatment of Certain Corporate Distributions (IRS Reform Act §6010(c)). The provision clarifies that the acquisitions described in section 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50% or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50% or greater interest.

In the case of acquisitions under section 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in the corporation by each person owning stock in the corporation immediately before the acquisition does not decrease.

Certain Preferred Stock Treated as "Boot" (IRS Reform Act §6010(e)). The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

The provision also clarifies that section 351(b), relating to the receipt of property, applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type.

Modify UBI Rules Applicable to Second-Tier Subsidiaries (IRS Reform Act §6010(j). The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from "unrelated business income" (UBI) is included in UBI if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or

accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Clarification of Allocation of Basis of Properties Distributed to a Partner by a Partnership (IRS Reform Act §6010(m)). The technical correction clarifies that for purposes of the allocation rules of section 732(c), "unrealized receivables" has the meaning in section 751(c) including the last two sentences of section 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of section 732(c) to property listed in the last two sentences of section 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.

Clarification of Expanding the Limitations on Deductibility of Premiums and Interest with Respect to Life Insurance, Endowment and Annuity Contracts (IRS Reform Act §6010(o)). The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A, then coverage for each such insured individual is treated as a separate contract for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20% owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

The technical correction clarifies that the required reporting to the Treasury Secretary is an information return and any reporting required to be made to any other person is a payee statement. Thus, the $50-per-report penalty imposed for failure to file or provide such an information return or payee statement applies. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

The technical correction clarifies that the treatment of additional covered lives under the effective date of the TRA of 1997 provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of sections 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of section 848(e)(2).

Information Reporting with Respect to Certain Foreign Corporations and Partnerships (IRS Reform Act §6011(f)).

The provision provides clarification and guidance relating to the furnishing of required information to be provided by the Secretary of the Treasury (not specifically through regulations) and conforms the use of the defined term "foreign business entity."

Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation (IRS Reform Act §6012(a)). The provision clarifies that prosecuting a federal crime or providing support services to the prosecution of a federal crime is considered part of investigating a federal crime, thus permitting these employees to deduct their travel expenses.

Modification of Distribution Rules for REITs (IRS Reform Act §6012(g)). The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95% of its REIT earnings, or any other requirement.

Provision of Regulatory Authority for Simplified Reporting of Funeral Trusts Terminated During the Taxable Year (IRS Reform Act §6013(b)). The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time.

Treatment of Certain Disability Payments to Public Safety Employees (IRS Reform Act §6015(c)). In order to address problems taxpayers are encountering with the IRS in seeking refunds under the old provision, the new provision clarifies the scope of the provision.

The provision provides that payments made on account of heart disease or hypertension of the employee received in 1989, 1990, or 1991 pursuant to a state law as described under present law, or received by an individual referred to in the state law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman, will be excludable from income.

Application of Requirements for SIMPLE IRAs in the Case of Mergers and Acquisitions (IRS Reform Act §6016(a)). The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transactions for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation. In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of section 410(b)(6)(C)(i) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Treatment of Indian Tribal Governments (IRS Reform Act §6016(a)). The provision clarifies that an employee participating in a 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to a section 401(k) plan maintained by the Indian tribal government.

Disclosure of Returns and Return Information (IRS Reform Act §6019(c)). The provision clarifies that disclosures to one ex or estranged spouse, whether there has been an attempt to collect the deficiency from the other ex or estranged spouse, that, like certain other disclosures permitted under present law, may be made to the duly authorized attorney in fact of the person making the disclosure request.

Treatment of Interest on Qualified Education Loans (Trade and Extenders Act §4003(a)). The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest. The provision also clarifies that, for purposes of phasing out the deduction, modified AGI is determined after application of section 135 (relating to income from certain U.S. saving bonds) and section 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan or under any contract purchased under a qualified employer plan.

Abatement of Interest by Reason of Presidentially Declared Disasters (Trade and Extenders Act §4003(e)). Under a provision of the TRA of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997, no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension period. The 1998 provision extends the rule so that it is available for disasters declared in 1997 or 1998 with respect to the 1997 tax year.

Determination of Unborrowed Policy Cash Value Under COLI Pro Rata Interest Disallowance Rules (Trade and Extenders Act §4003(i)). The provision clarifies the meaning of "unborrowed policy cash value" with respect to any life insurance, annuity or endowment contract. The technical correction clarifies that if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association or Insurance Commissioners, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or (3) such other amount as is determined by the Treasury Secretary.

Casualty Loss Deductions (Trade and Extenders Act §4004). The provision clarifies that all deductions for nonbusiness casualty and theft losses are taken into account in computing an NOL. Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2% adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

12. Technical Amendments

This bill would make five technical amendments to the Revenue and Taxation Code. Two of the technical amendments remove obsolete IRC references relating to installment sales, one adds a Corporations Code reference relating to penalties and two of the amendments relating to involuntary conversions are clean-up to SB 519 (Stat. 1998, Ch. 7). No revenue is associated with any of these "code

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer, particularly when dealing with complex areas such as those proposed in this bill. With conformity, the taxpayer will only be required to know one set of rules. Conformity also eases FTB's administration of the law by utilizing many federal forms and instructions. This bill conforms to numerous federal law changes that occurred in 1998.